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August 27, 2010

The Honorable Jocelyn Boyd
Chief Clerk of the Commission
Public Service Commission of South Carolina
Post Office Drawer 11649
Columbia, South Carolina 29211

Re: Complaint and Petition for Relief of BellSouth Telecommunications, Inc. d/b/a AT&T Southeast d/b/a AT&T South Carolina v. Affordable Phone Services, Inc. d/b/a High Tech Communications, Dialtone & More, Inc., Tennessee Telephone Service, LLC d/b/a Freedom Communications USA, LLC, OneTone Telecom, Inc., dPi Teleconnect, LLC and Image Access, Inc., d/b/a New Phone
Docket No. 2010-14-C, Docket No. 2010-15-C, Docket No. 2010-16-C, Docket No. 2010-17-C, Docket No. 2010-18-C, & Docket No. 2010-19-C

Dear Ms. Boyd:

Enclosed for filing in the Consolidated Phase of the above-referenced matters, with regard to all Respondents except Tennessee Telephone Service, LLC ("Tennessee Telephone"), is the Direct Testimony of Dr. William E. Taylor on behalf of AT&T South Carolina.

On August 24, 2010, Tennessee Telephone Service, LLC ("Tennessee Telephone") filed a Notice of Bankruptcy ("Notice") in Dockets No. 2010-14-C through 2010-19-C. This Notice states that Tennessee Telephone "is a Chapter 11 Debtor in the U.S. Bankruptcy Court for the Middle District of Tennessee, Case No. 10-08252, which was filed on August 4, 2010" and that "litigation to which [Tennessee Telephone] is a party is subject to the automatic stay." By filing this testimony with regard to the remaining Respondents in the Consolidated Phase, AT&T is not attempting to pursue any litigation with regard to Tennessee Telephone.

Moreover, AT&T has filed a motion with the bankruptcy court seeking a determination that: (1) the automatic stay does not apply to the Consolidated Phase of these proceedings as against Tennessee Telephone; or, (2) in the alternative, there is cause for granting relief from the automatic stay in order to allow the Consolidated Phase to proceed with respect to claims against Tennessee Telephone. AT&T South Carolina will notify the Commission of the outcome of that motion and, of course, will comply with all rulings of the bankruptcy court.

By copy of this letter, I am serving all parties of record with a copy of this testimony as indicated on the attached Certificate of Service.

Sincerely,

Patrick Turner

Patrick W. Turner

PWT/nml
Enclosure
cc: All Parties of Record
843076

ON BEHALF OF BELLSOUTH TELECOMMUNICATIONS, INC.

DIRECT TESTIMONY OF DR. WILLIAM E. TAYLOR

BEFORE THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

DOCKET NOS. 2010-14-C TO 2010-19-C

AUGUST 27, 2010

I. INTRODUCTION AND SUMMARY

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND CURRENT POSITION.

A. My name is William E. Taylor. I am a Special Consultant to NERA Economic Consulting, Inc. (NERA). For many years, I was head of its telecommunications economics practice and head of its Boston office.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL, PROFESSIONAL, AND BUSINESS EXPERIENCE.

A. I received a B.A. degree in economics, magna cum laude, from Harvard College in 1968, a master's degree in statistics from the University of California at Berkeley in 1970, and a Ph.D. in economics from Berkeley in 1974, specializing in econometrics and industrial organization. I have taught and published research in the areas of theoretical and applied econometrics in industrial organizations, microeconomics, and telecommunications economics at academic institutions (including the economics departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology) and at research organizations (including Bell Laboratories and Bell

Communications Research, Inc.).

My research has been published in peer-reviewed journals such as *Econometrica*, the *American Economic Review*, the *International Economic Review*, the *Journal of Econometrics*, *Econometric Reviews*, the *Antitrust Law Journal*, and *The Review of Industrial Organization*, and I have contributed to The Encyclopedia of Statistical Sciences. I have served as a referee for these journals (and others) and for the National Science Foundation, as an Associate Editor of the *Journal of Econometrics*, and as a commentator on the PBS Nightly News Hour. I have testified in U.S. federal and state courts and the New Zealand High Court as an economic and statistical expert, and I have participated in telecommunications regulatory proceedings before state public service commissions, the Federal Communications Commission, the Canadian Radio-Television and Telecommunications Commission, the New Zealand Commerce Commission, the Indonesian antitrust authority, the Comisión Federal de Telecomunicaciones de México, and federal and state congressional committees. I have appeared before the Public Service Commission of South Carolina in Docket Nos. 97-101-C, 97-374-C, 97-124-C, 1999-259-C, 2001-209-C, 2002-367-C and 2002-408-C regarding economic issues concerning long distance entry and pricing, pricing and costing of interconnection services, statistical aspects of performance penalty plans, and economics of price cap regulation. Attached as Exhibit WET-1 to my testimony is a copy of my curriculum vitae, which outlines my professional qualifications, my publications, and cases in which I have testified.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been asked to explain, as an economist, how the resale provisions in the Telecommunications Act of 1996 ("the 96 Act") as promulgated by the Federal Communications Commission ("FCC") and implemented by the Public Service Commission of South Carolina ("the Commission") apply to the three types of promotional offerings under consideration in the Consolidated Phase of this proceeding. Specifically, I address the amount of credit a reseller should receive for qualifying cashback and Line Connection Charge Waiver ("LCCW") promotions. For the Word-of-Mouth referral reward program, I discuss from an economic perspective why such programs are not subject to resale in the first place and, if the Commission disagrees and finds that they are subject to resale, what the proper amount of credit would be for qualifying resellers.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. My testimony provides a brief procedural summary of these proceedings; discusses the economics of both ordinary resale and the resale of promotions; shows that AT&T's method of reselling cashback and line connection charge waiver promotions is appropriate; and explains why word-of-mouth promotions are not subject to resale and why, even if they were, the wholesale price of the telecommunications services should remain unaffected by the promotion.

II. PROCEDURAL SUMMARY

Q. PLEASE EXPLAIN HOW THIS MATTER CAME BEFORE THE COMMISSION.

A. In January 2010, AT&T filed separate Complaints against six resellers and asked the Commission to: resolve billing disputes between AT&T and each reseller; determine the amount each reseller owes AT&T under its interconnection agreement(s); and require each reseller to pay those amounts to AT&T.

On May 20, 2010, AT&T and each of the six resellers filed a Joint Motion on Procedural Issues ("Joint Motion") asking the Commission to convene this Consolidated Phase of these proceedings to resolve the following issues that are common to each of the six separate complaint proceedings:

(a) how cashback credits to the resellers should be calculated;[1]

(b) whether the word-of-mouth promotion is available for resale and, if so, how the credits to resellers should be calculated; and

(c) how credits to resellers for waiver of the line connection charge should be calculated.

See Joint Motion at 2. The Joint Motion provides that after the Commission has issued an order resolving these issues, the Parties will "work in good faith to address or, if necessary, request the Commission to resolve, all remaining unresolved claims and counterclaims related to the Consolidated Phase and determine what, if any, dollar amounts are owed or credits due each Party." *Id.*

[1] The Joint Motion clarifies that the Parties are not asking the Commission to decide any other issues, including issues related to AT&T's announcement of its intent to

(continued...)

at 3. The Joint Motion explains the Parties' belief that proceeding in this manner will "promote the reasonable, efficient, and expeditious determination of these proceedings . . . ." *Id.* at 2.

Q. COULD YOU BRIEFLY DISCUSS THE STIPULATIONS THE PARTIES HAVE FILED IN THIS CONSOLIDATED PHASE?

A. Yes. On July 23, 2010, the Parties submitted Stipulations for Consolidated Phase ("Stipulations") for use in resolving the three issues presented in the Consolidated Phase. These Stipulations explain that with regard to the cashback and line connection waiver issues, in this Consolidated Phase, the Parties ask the Commission to assume that the Parties agree that a reseller is entitled to receive a promotional credit and that the only dispute is the amount of the credit to which the reseller is entitled. *See* Stipulations at 2. With regard to the Word-of-Mouth referral reward program, in the Consolidated Phase, the Parties ask the Commission to make an initial determination as to whether that program is subject to the resale obligations of applicable law. *Id.* at 3. If the Commission determines that it is — and I recommend against any such finding — the Parties ask the Commission to further assume that the Parties agree that a reseller is entitled to receive a promotional credit and that the only dispute is the amount of the credit to which the reseller is entitled. *Id.* at 3.

(...continued)

change its formula for calculating cashback credits, in this Consolidated Phase.

Q. DOES THIS MEAN THERE ARE NO DISAGREEMENTS AS TO WHETHER A PARTICULAR RESELLER IS ENTITLED TO A PARTICULAR PROMOTIONAL CREDIT THAT IS AT ISSUE IN ANY OF THE SIX INDIVIDUAL COMPLAINT PROCEEDINGS?

A. No. There may be disagreements, for instance, as to whether a reseller's end user qualifies for a promotion, whether a reseller timely submitted a request for a promotional credit or whether a reseller has sufficient documentation to substantiate its credit claim. As I understand it, however, the Parties have agreed not to present those disagreements now so the Commission can give overall guidance on the three issues presented in the Consolidated Phase. The Parties are hopeful that, upon receiving that guidance, they can amicably resolve most, if not all, of any differences that may remain. To the extent they cannot, however, they will present any remaining differences to the Commission for resolution in later phases of these proceedings. *See* Stipulations at 3-4.

III. ECONOMICS OF RESALE

A. Ordinary Resale

Q. WHAT FEDERAL RULES GOVERN THE TYPES OF RESALE AT ISSUE IN THIS PROCEEDING?

A. Section 251(c)(4) of the 96 Act requires ILECs

> (A) to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers; and
>
> (B) not to prohibit, and not to impose unreasonable or discriminatory

> conditions or limitations on, the resale of such telecommunications service, except that a State commission may, consistent with regulations prescribed by the Commission under this section, prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of subscribers from offering such service to a different category of subscribers.

This requirement is implemented in various FCC rules (§§ 51.601 to 51.617). Specifically, § 51.603 of the FCC's rules, entitled "Resale obligation of all local exchange carriers," provides that:

> (a) A LEC shall make its telecommunications services available for resale to requesting telecommunications carriers on terms and conditions that are reasonable and non-discriminatory.
>
> (b) A LEC must provide services to requesting telecommunications carriers for resale that are equal in quality, subject to the same conditions, and provided within the same provisioning time intervals that the LEC provides these services to others, including end users.

Q. HOW ARE RESOLD SERVICES AT ISSUE IN THIS PROCEEDING PRICED?

A. The FCC's rules [§ 51.607] require state public utility commissions to set the resale price for a service equal to the retail price less the costs avoided by the ILEC when it serves a customer at wholesale rather than retail. Avoided costs are generally calculated by measuring the costs in particular accounting categories associated with marketing, billing and collection and customer service.

Q. HOW ARE THOSE AVOIDED COSTS USED TO CALCULATE THE WHOLESALE PRICE FOR A TELECOMMUNICATIONS SERVICE THAT IS SUBJECT TO RESALE?

A. First, those avoided costs are expressed as a percentage of total retail revenues.

Then the wholesale price for a particular service is (almost always) calculated as a uniform percentage discount off of the retail price given by multiplying the retail price for the service in question by a number equal to one minus the avoided cost percentage. For example, if avoided costs were $20 and total retail revenues were $100, the avoided cost percentage would be 20 percent. If the retail price of a service were $50, the wholesale price would be $40 [$50×(1-0.20)].

Q. DOES THE FCC REQUIRE STATE COMMISSIONS TO USE THIS METHODOLOGY TO CALCULATE THE WHOLESALE RATE FOR A TELECOMMUNICATIONS SERVICE THAT IS SUBJECT TO RESALE?

A. No, the FCC does not require the wholesale rate to be calculated as a uniform percentage discount.

> 916. We neither prohibit nor require use of a single, uniform discount rate for all of an incumbent LEC's services. We recognize that a uniform rate is simple to apply, and avoids the need to allocate avoided costs among services. Therefore, our default wholesale discount is to be applied uniformly. On the other hand, we also agree with parties who observe that avoided costs may, in fact, vary among services. Accordingly, we allow a state to approve nonuniform wholesale discount rates, as long as those rates are set on the basis of an avoided cost study that includes a demonstration of the percentage of avoided costs that is attributable to each service or group of services. [*First Report and Order*, ¶ 916]

Nonetheless, the default rates that the FCC calculated for use by states that did not produce cost studies were calculated as a uniform percentage discount, and all state Commissions in the former BellSouth's nine-state area use a percentage discount method (although some have different rates for business and residence services or for services that include or exclude billing and collection services).

Q. HOW DOES SOUTH CAROLINA REQUIRE THAT RESOLD SERVICES BE PRICED?

A. For the residential services at issue in this Consolidated Phase, the uniform resale discount rate adopted by this Commission is 14.8 percent. *See* Order on Arbitration, *In Re: Petition of AT&T Communications of the Southern States, Inc. for Arbitration of an Interconnection Agreement with BellSouth Telecommunications, Inc.*, Order No. 97-189 in Docket No. 96-358-C at 14 (March 10, 1997).

Q. WHY IS THE AVOIDED-COST DISCOUNT CALCULATED AS A UNIFORM PERCENTAGE DISCOUNT?

A. It is calculated that way partly for administrative ease and partly for a good economic reason.

Q. WHAT IS THE GOOD ECONOMIC REASON?

A. A large portion of a telecommunications company's costs are common across the services it supplies. The network is a platform over which many retail services, wholesale services and unregulated services are supplied, and there is no economically meaningful way to assign those common costs to particular services. Even large portions of the types of costs that are avoided when a customer is served at wholesale are common across retail services: *e.g.*, generic brand marketing, customer support infrastructure, *etc.* Thus, it would make no economic sense to calculate an avoided cost for each retail service.

B. Resale of Promotions

Q. WHAT FUNCTIONS DO PROMOTIONS LIKE THE ONES AT ISSUE IN THIS CONSOLIDATED PHASE SERVE IN ECONOMIC THEORY?

A. As the FCC recognized in Paragraph 949 of its *First Report and Order*, "promotions that are limited in length may serve procompetitive ends through enhancing marketing and sales-based competition." Indeed, promotions in general allow firms to reduce prices profitably in circumstances where an overall, permanent price reduction would be unprofitable. This opportunity arises when a promotion is attractive to customers who are relatively price-sensitive but unattractive to customers who are relatively less price-sensitive. For example, January white sales are a familiar promotion in which customers who can target their purchases to January can pay a lower price than customers who need new sheets in August. Department stores run regular and predictable clearance sales as the seasons change so customers who can wait can buy discounted coats in February or bathing suits in August. Similarly, customers who take the time to plan their grocery shopping and clip coupons can pay a lower price than those who don't. For the telecommunications promotions at issue in this proceeding, non-AT&T customers considering a change in their carrier can switch at any time to AT&T and pay the tariffed rate or take advantage of the promotional offers then in place. Alternatively, if no satisfactory promotion is currently in effect and they can wait a few weeks, they can time their service change to take advantage of whatever new promotions have rolled out. In either case, customers who can wait can generally take advantage of services at effectively lower prices.

In economic theory, such promotions generally result in increased demand for the products or services, and when they do, they also increase aggregate economic welfare (that is, the sum of producer and consumer surplus). Consumers are better off because some see price reductions that would otherwise not have occurred, and the rest are no worse off. Firms are better off because such targeted price reductions increase profits.[2]

Q. ARE SUCH PROMOTIONS COMMON IN UNREGULATED, COMPETITIVE MARKETS?

A. Absolutely. The US economy is awash in promotions vying for the consumers' dollar. Cashback promotions in which the customer must fill out a coupon to request a payment are standard offerings for software, computers, television sets, home appliances, cellular telephones and other electronic equipment. "Free" or discounted additional products or services are common in retail stores ("buy one, get one free"), legal and dental practices (waiving the initial

[2] See, *e.g.*, H. R. Varian. "Price Discrimination," in R. Schmalensee and R. D. Willig, editors, *Handbook of Industrial Organization*, Volume I, pages 597-654. Elsevier, 1989 or D. Carlton and J. Perloff, *Modern Industrial Organization*, 4th edition, Chapter 9.

consultation fee), credit cards (waiving the annual fee for the first year), baseball (bat or jersey nights), airlines (frequent flier miles), etc. Promotions involving unrelated products or services include the classic free toaster for opening a bank account,[3] drinking glasses with a gasoline fill-up and restaurant discounts tied to a movie or theater ticket. Promotions involving marketing services include travel agency tote bags, magazine logos on coffee cups, multi-level marketing for household products, etc.

Q. IN ADDRESSING RESALE IN GENERAL, DID THE FCC SPECIFICALLY ADDRESS PROMOTIONAL OFFERINGS?

A. Yes. In ¶¶ 940-953 of the 1st Report & Order, the FCC concludes that there is no general exemption of promotions from the ILECs' resale obligation, but that

> ...promotions that are limited in length may serve procompetitive ends through enhancing marketing and sales-based competition and we do not wish to unnecessarily restrict such offerings. We believe that, if promotions are of limited duration, their procompetitive effects will outweigh any potential anticompetitive effects. We therefore conclude that short-term promotional prices do not constitute retail rates for the underlying services and are thus not subject to the wholesale rate obligation. [¶ 949]

In other words, to encourage competition, the FCC exempted short-term promotions—which it limited to ninety days in ¶ 950—from the ILECs' obligation to resell at an avoided cost discount.

Q. IF LIMITED-TIME PROMOTIONS ARE COMMON AND PROCOMPETITIVE,

[3] In August 2010, for example, I received in my mailbox a flier from Bank Gloucester (Massachusetts) offering me my choice of a 12-can sling cooler, a Sherpa day pack

(continued...)

WHY DID THE FCC REQUIRE RESALE OF LIMITED-TIME PROMOTIONS OFFERED FOR LONGER THAN NINETY DAYS?

A. To preserve the resale obligation. While recognizing that promotions are generally procompetitive, the FCC reasoned that excusing all promotions from the resale obligation

> … would permit incumbent LECs to avoid the statutory resale obligation by shifting their customers to nonstandard offerings, thereby eviscerating the resale provisions of the 1996 Act. [*First Report and Order*, ¶ 948]

In other words, because ILEC retail telecommunications services generally were required to be resold at an avoided-cost discount, it was necessary to draw a line between short-term promotions—to which the resale obligation did not apply—and longer-term promotions that could be used to evade the resale obligation generally. Thus, the decision to apply the resale obligation to promotions of greater duration than ninety days was designed to maintain the resale requirement and was not an indication that such promotions were likely to be anticompetitive.

Q. IS THIS "LIMITED TIME" EXCEPTION AT ISSUE IN THIS CONSOLIDATED PHASE OF THESE PROCEEDINGS?

A. No. AT&T is not claiming in the Consolidated Phase that it is exempt from the obligation to resell the cashback or line connection charge waiver offerings at an avoided cost discount. *See* Stipulations at 6, ¶¶ 7-9.

(...continued)

or an electric sandwich maker for opening a new checking account.

Similarly, AT&T is not claiming in the Consolidated Phase that this "limited time" exception relieves it of any resale obligations that may otherwise apply to its Word-of-Mouth referral reward program. Instead, AT&T is claiming (correctly, as I explain below) that its Word-of-Mouth referral reward program is not subject to any resale obligations in the first place.

IV. RESALE OF CASHBACK PROMOTIONS

Q. WHAT ARE CASHBACK PROMOTIONS?

A. As described in Attachment A to the Stipulations, a cashback promotion is an offer that provides a one-time cash or near-cash incentive for customers to subscribe to a service. It often takes the form of a coupon to be mailed back or an online redemption process. If the customer mails in the coupon or completes the online redemption process and is otherwise eligible, she receives some kind of cash equivalent: for example, a check, a bill credit or a credit card for the established amount.

Q. FOR THE PURPOSES OF THIS CONSOLIDATED PHASE, HOW DOES AT&T MAKE CASHBACK PROMOTIONS AVAILABLE FOR RESALE?

A. AT&T resells cashback promotions by billing qualifying resellers the monthly retail price of the telecommunications service less the 14.8 percent resale discount and by providing the reseller a one-time bill credit in the amount of the retail cashback amount less the 14.8 percent resale discount. *See* Stipulations at 6, ¶¶ 7-9.

Suppose, for example, a $75 per month retail service is promoted for more than 90 days by means of a $50 cashback offer. Each month, AT&T bills a qualifying reseller $63.90 per month (the $75.00 retail price less the 14.8 percent residential resale discount established by the Commission) for the telecommunications service. Then, if the reseller submits a valid promotional credit request, AT&T provides the reseller a one-time bill credit in the amount of $42.60 (the $50 retail cashback value less the 14.8 percent residential resale discount established by the Commission).

AT&T, therefore, treats the $50 cashback component of the promotional offering as a one-time $50 reduction in the retail price of the telecommunications service. See Table A.

Table A
$50 Cashback as a $50 Price Reduction

Regular Recurring Retail Monthly Price	$75.00		Regular Recurring Wholesale Price	$63.90
Retail Price for the Month with the One-Time Promotional Credit	$25.00		Wholesale Price for the Month with the One-Time Promotional Credit	$21.30
Retail Price Reduction	$50.00		Wholesale Price Reduction	$42.60

Q. FROM AN ECONOMIC PERSPECTIVE, IS THIS AN APPROPRIATE TREATMENT OF A CASHBACK PROMOTION?

A. Yes. Whenever the cashback benefit is sufficiently close to cash, it is appropriate from an economic perspective to take the effect of the cashback on the retail price of the telecommunications service into account in determining the wholesale price. Moreover, treating a $50 cashback offer as a $50 reduction in the retail price of the telecommunications service maintains the 14.8 percent resale discount established by the Commission. This is shown in Table B in which the wholesale prices are 14.8 percent less than the retail prices.

Table B
Discounting the $50 Cashback Maintains the Commission-Ordered Wholesale Margin

	Regular Recurring Monthly Price	Price for the Month with the One-Time Promotional Credit	Difference
Retail Price	$75.00	$25.00	$50.00
Wholesale Price	$63.90	$21.30	$42.60
% Difference	14.80%	14.80%	
$ Difference	$11.10	$3.70	

Thus, when a $50 cashback offer reduces the retail price of the service by $50 in the month the credit is given, reducing the wholesale price by $42.60 in the same month — giving the qualifying reseller a bill credit of $42.60 — maintains the resale discount at the Commission-mandated 14.8 percent. Of course, a $50 cashback offer can have a much smaller effect on the retail price, so this calculation can be a very conservative treatment of the cashback promotion.

Q. WHY DO YOU SAY THIS CAN BE A "VERY CONSERVATIVE TREATMENT OF THE CASHBACK PROMOTION"?

A. Because the actual impact of a one-time, up-front $50 cashback offering on the retail price of the telecommunications service could be substantially less than

$50, depending on a number of factors including, without limitation, the redemption rate, the in-service life of the subject customer, and the discount rate used to calculate the net present value of a one-time, up-front payment associated with the promotion. From an economic perspective, AT&T appropriately could use those factors to determine the actual effect the $50 cashback component of a promotion has on the retail price of the telecommunications service and then calculate the wholesale price accordingly. *See*, e.g., *BellSouth Telecom. Inc. v. Sanford*, 494 F.3d 439 (4th Cir. 2007). In fact, for a brief time, AT&T did calculate the wholesale price in that manner, but AT&T is not seeking any relief in these proceedings on the basis of that calculation. *See*, e.g., Complaint in Docket No. 2010-18-C at 1 n.1. Additionally, the Parties are not asking the Commission to decide any issues related to that calculation in this Consolidated Phase. *See* Joint Motion on Procedural Issues at 2, n.2.

Q. UNDER AT&T'S METHOD OF RESELLING CASHBACK PROMOTIONAL OFFERINGS, THE RESELLER RECEIVES ONLY A $42.60 ONE-TIME BILL CREDIT WHEN THE RETAIL CUSTOMER RECEIVES A ONE-TIME $50 CASHBACK BENEFIT. IS THAT APPROPRIATE?

A. Yes. In the example above, the reseller receives a one-time $42.60 credit for a service for which it pays $63.90 a month. AT&T's retail customer receives a one-time $50 credit for a service for which she pays $75 per month. In the first month of service, the reseller pays $21.30 ($63.90 - $42.60) while the retail customer pays $25 ($75 - $50). In the first month of service, therefore, the reseller pays 14.8 percent less than the retail customer, exactly as the Commission orders establishing the residential resale discount rate require.

Q. PLEASE COMPARE HOW A RESELLER FARES UNDER THIS METHOD OF RESELLING CASHBACK PROMOTIONAL OFFERINGS TO HOW THE RESELLER WOULD FARE IF AT&T SIMPLY REDUCED THE RETAIL PRICE OF THE SERVICE BY $50 IN THE FIRST MONTH.

A. The reseller fares exactly the same in both cases. To illustrate this point, assume that instead of giving the retail customer a one-time $50 cashback benefit, AT&T had simply reduced the retail price of the service by $50 (from $75 to $25) in the first month. AT&T's retail customer would then pay $25 in the first month and $75 per month thereafter. A reseller of that service would thus pay the wholesale price of $21.30 ($25 less the 14.8 percent resale discount) in the first month and $63.90 ($75 less the 14.8 percent resale discount) per month thereafter. The reseller would thus receive a reduction in the wholesale price of the service of $42.60 in the first month (from $63.90 to $21.30), which corresponds exactly with the $50 "face value" of the cashback promotion less the 14.8 percent resale discount. Thus, treating the $50 cashback promotion as a price reduction in the first month of service means that the reseller would receive a bill credit of $42.60 in the first month of service, not $50.[4]

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[4] Conversely, if AT&T increased its retail price by $50, the wholesale price a reseller would pay for the same service would increase by only $42.60. In absolute dollar (continued...)

Q. UNDER AT&T'S METHOD OF RESELLING CASHBACK PROMOTIONS, IS THE RESELLER'S ACTUAL MARGIN SMALLER UNDER THE PROMOTION?

A. That depends on what is meant by "margin." The actual impact of the one-time promotional credit on the reseller's profit margins — the difference between the price it charges its customers and the wholesale price it pays to AT&T — depends on whether (and, if so, how) the reseller reflects the credit in the prices it charges its own end-user customers. Under the promotion, the reseller clearly pays a lower wholesale price for the telecommunications services it orders from AT&T. In the example above, for instance, the regular monthly wholesale recurring charge is $63.90, and in the first month, the wholesale price drops to $21.30. In that first month, therefore, the reseller pays $42.60 less for the service it buys from AT&T. Accordingly, if the reseller does not voluntarily reduce its retail price in the first month, it would receive a substantial *increase* in its profit margin under the promotion, not a decrease.

In fact, resellers have total freedom to determine how to reflect their $42.60 wholesale cashback credit in their retail prices, if at all. They can offer their own customers an opportunity to claim a $50 cashback offer (recognizing that not all customers who qualify will claim the credit). They can reduce their retail prices to reflect their cost savings. Or they can do nothing at all for their retail customers

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(...continued)

terms, therefore, wholesale price increases are less than retail price increases, and (continued...)

and simply treat the $42.60 credit as a $42.60 improvement in their own corporate profit margin in that month.[5]

That said, Table B shows that the absolute dollar "margin" — the difference between AT&T's retail and wholesale prices — falls from $11.10 for the recurring monthly service to $3.70 in the month the reseller receives the promotional credit. However, this fact is of no competitive significance for several reasons. First, the "prepay" resellers that are parties to this Consolidated Phase target credit-challenged end-user customers and typically charge them prices that are significantly higher than AT&T's prices for the same telecommunications services. Second, the $42.60 cashback credit is a sizable one-time reduction in the resellers' wholesale costs, relative to what the reseller pays AT&T on a recurring monthly basis. Third (and dispositive), under AT&T's method, the *percentage* "margin" between AT&T's retail and wholesale rates remains at the 14.8 percent discount rate determined by this Commission to reflect the avoided costs of resale.

Q. SOME RESELLERS HAVE ARGUED THAT UNLESS THEY RECEIVE A FULL $50 BILL CREDIT INSTEAD OF A $42.60 BILL CREDIT, AT&T IS TREATING

(...continued)

wholesale price decreases are less than retail price decreases.

[5] In contrast, for AT&T, the $50 cashback promotion is an actual one-time $50 cash or cash-like benefit to each subscriber who claims it and a corresponding increase in AT&T's service cost in that month.

ITS OWN RETAIL CUSTOMERS MORE FAVORABLY THAN ITS WHOLESALE CUSTOMERS. IS THAT A LEGITIMATE CLAIM?

A. No. This argument mixes apples and oranges. First, as noted above, not all of AT&T's eligible customers claim the $50 credit, but the resellers claim the credit on every line that qualifies. Thus, on a "cost per eligible subscriber" basis, the resellers receive a *higher* average per-line credit than AT&T's retail customers, not a lower one. Second, as shown in Table C, giving the reseller a full $50 price reduction in the first month would give it a far greater discount than the 14.8 percent mandated by this Commission: the percentage discount would increase to over 44 percent under the promotion.

Table C
A $50 Bill Credit Would Violate the Commission-Mandated Percentage Wholesale Margin

	Regular Recurring Monthly Price	Price for the Month with the One-Time Promotional Credit	Difference
Retail Price	$75.00	$25.00	$50.00
Wholesale Price	$63.90	$13.90	$50.00
% Difference	14.80%	44.40%	
$ Difference	$11.10	$11.10	

Q. IS THIS TREATMENT PROPOSED BY THE RESELLERS CONSISTENT WITH THE WAY THE FCC AND THIS COMMISSION HAVE TREATED RESALE IN THE PAST?

A. No. As explained in Section III A, it is the *percentage* difference between the retail and wholesale prices—not the absolute dollar difference—that the FCC used to set default wholesale rates and that this Commission used in establishing the 14.8 percent resale discount rate in South Carolina.

Paying resellers the full $50 cashback would treat the cashback promotion as something different from a price reduction, and it would not maintain the 14.8 percent difference between retail and wholesale prices that the Commission established. Indeed, qualifying resellers would get a much greater discount in the month the credit was issued — 44.4 percent instead of the Commission-approved 14.8 percent.

Q. DOES YOUR ANSWER CHANGE IF YOU TREAT THE $50 CASHBACK AS A PRICE REDUCTION OVER THE LIFE OF THE CUSTOMER INSTEAD OF A PRICE REDUCTION IN JUST THE FIRST MONTH?

No, the same analysis applies: under that analysis, AT&T's method treats the cashback promotion as a price reduction and still maintains the 14.8 percent discount in all periods. In Table 1 (at the end of this testimony), I show the impact of spreading the $50 cashback as a price reduction over the life of a customer (i.e., treating the $50 as a one-time $50 discount if the customer stays with AT&T or the reseller for only one month, treating the $50 as a $25 per-month discount if the customer stays with AT&T or the reseller for two months, etc.). This analysis shows that under AT&T's method, the reseller receives the full 14.8 percent discount in every period, as applicable Commission orders require.

Table 1 also shows the "absolute" difference between the wholesale cost to the reseller and the effective retail price being charged to AT&T's end-user customer. While the competitive significance of this number is dubious for the reasons discussed above (e.g., the reseller is under no obligation to charge the same end-user rates as AT&T, it need not provide its own customers with all or any of the value of the cashback credit and the percentage difference between AT&T's retail and wholesale prices remains unchanged), the analysis shows that as the customer's tenure increases over time, the absolute dollar difference between AT&T's effective retail and wholesale prices trends towards the same $11.10.

For illustrative purposes, Table 2 shows what would happen over time if AT&T were required to give the reseller the full $50 bill credit (instead of $42.60) as some resellers have proposed in other proceedings. That analysis shows that the effective wholesale discount would always exceed the 14.8 percent established by this Commission.

Q. WHICH WHOLESALE DISCOUNT IS CORRECT—A CONSTANT DOLLAR MARGIN AS SHOWN IN TABLE 2 OR A CONSTANT PERCENTAGE MARGIN AS SHOWN IN TABLE 1?

A. Neither form of the wholesale discount is necessarily better than the other from a purely economic perspective. A $10 margin (between retail and wholesale prices) is obviously more competitively significant when the service is priced at $5 than when it is priced at $50. Similarly, a 20 percent margin may be generous on a $50 service but much less so if the service were sold for $5.

In the context of this proceeding, however, there is more than economic theory to consider. First, as explained above, whether a reseller's end-user customer actually receives *any* benefit as a result of an AT&T retail cashback promotion is difficult, if not impossible, to determine because there is no guarantee or requirement that the reseller provide its end-user customers any portion of the one-time reduction in its wholesale costs. Second, as Table 2 demonstrates, requiring AT&T to provide resellers a credit in the full retail cashback amount gives resellers (especially those who may be affiliated with one another) an incentive to churn their end-user customers as quickly as possible. Third, under the rules of the FCC as implemented by this Commission, and as expressed in the relevant interconnection agreements, the wholesale price of a resold service must be set at a uniform discount by multiplying the retail price by one minus the resale discount of 14.8 percent.[6] AT&T's method of reselling cashback promotions maintains the 14.8 percent proportional difference; providing

[6] Going forward, if a party thought a different method of calculating resale discounts was preferable, it would have to justify its proposed method using service-specific cost studies consistent with ¶ 916 of the *First Report and Order,* which "allow[s] a state to approve nonuniform wholesale discount rates, as long as those rates are set on the basis of an avoided cost study that includes a demonstration of the percentage of avoided costs that is attributable to each service or group of services."

resellers the full retail value of the cashback (as resellers have proposed in various other settings) does not. Thus, the Commission should find that AT&T's resale obligation is to provide the reseller with the cashback promotion less the 14.8 percent Commission-approved discount.

Q. IN THE EXAMPLES YOU HAVE DISCUSSED, THE MONTHLY PRICE OF THE TELECOMMUNICATIONS SERVICE IS GREATER THAN THE RETAIL CASHBACK BENEFIT. COULD YOU PROVIDE SIMILAR EXAMPLES WHEN THE MONTHLY PRICE OF THE SERVICE IS LESS THAN THE ONE-TIME RETAIL CASHBACK BENEFIT?

A. Yes. Assume that the monthly retail price of the telecommunications service is $75 and the one-time retail cashback benefit is $100. Under AT&T's method of reselling cashback promotions, the reseller would pay AT&T $63.90 each month for the telecommunications service ($63.90=$75 less the 14.8 percent wholesale discount) and, if it qualified for the cashback promotional offering, the reseller would receive a one-time bill credit in the amount of $85.20 from AT&T ($85.20=$100 less the 14.8 percent wholesale discount). See Table D.

Table D
$100 Cashback as a $100 Price Reduction

Regular Recurring Retail Monthly Price	$75.00		Regular Recurring Wholesale Price	$63.90
Retail Price for the Single Month with the One-Time Promotional Credit	($25.00)		Wholesale Price for the Single Month with the One-Time Promotional Credit	($21.30)
Retail Price Reduction	$100.00		Wholesale Price Reduction	$85.20

In the first month, therefore, AT&T pays its retail customer $25 (net) to take the service, and it pays a qualifying reseller $21.30 (net) to serve its customer on a resale basis. The result is that the wholesale price is still the same avoided-cost discount off of the retail price. See Table E.

Table E
Discounting the $100 Cashback Maintains the Commission-Ordered Wholesale Margin

	Regular Recurring Monthly Price	Price for the Single Month with the One-Time Promotional Credit	Difference
Retail Price	$75.00	($25.00)	$100.00
Wholesale Price	$63.90	($21.30)	$85.20
% Difference	14.80%	14.80%	
$ Difference	$11.10	($3.70)	

Significantly, the fact that the retail price is negative in this case (which only occurs in the first month of service) shows that AT&T would not offer a $100 cashback promotion on a $75 per month service unless it expected to retain the customer for enough months to make the promotion profitable.

Q. WHAT WOULD BE THE EFFECT OF A $100 BILL CREDIT (INSTEAD OF THE $85.20 PROVIDED BY AT&T) FOR QUALIFYING RESELLERS IN THIS EXAMPLE?

A. The absolute dollar margin between the retail and wholesale rates would be the same in the original service and the promotion but the wholesale discount would no longer be the 14.8 percent rate established by the Commission. See Table F.

Table F
A $100 Bill Credit Would Violate the Commission-Mandated Percentage Wholesale Margin

	Regular Recurring Monthly Price	Price for the Single Month with the One-Time Promotional Credit	Difference
Retail Price	$75.00	($25.00)	$100.00
Wholesale Price	$63.90	($36.10)	$100.00
% Difference	14.80%	-44.40%	
$ Difference	$11.10	$11.10	

Thus, giving the reseller the full $100 cashback credit would not treat the $100 cashback as a retail price reduction and would not maintain the Commission-established wholesale discount.

Q. DOES THIS ANALYSIS CHANGE IF YOU TREAT THE $100 CASHBACK AS A PRICE REDUCTION OVER THE LIFE OF THE CUSTOMER INSTEAD OF A PRICE REDUCTION IN JUST THE FIRST MONTH?

A. No, as shown in Table 3 (attached at the end of the testimony). In every month — from the first month onward — the wholesale price is equal to the retail price less the 14.8 percent resale discount, as required by the AT&T-CLEC interconnection agreements and as set by this Commission. Applying the wholesale discount to the cashback amount results in wholesale prices equal to the regulated wholesale discount off of the retail rate.

In contrast, Table 4 assumes that the reseller receives a bill credit equal to the full $100 retail cashback amount. Here, in every month after the first, the wholesale discount exceeds the 14.8 percent discount established by the Commission.

Q. IN TABLE 3 AND TABLE 4, THE EFFECTIVE RETAIL PRICES IN THE FIRST MONTHS ARE NEGATIVE, AND THEY ARE "MORE NEGATIVE" THAN THE EFFECTIVE WHOLESALE PRICE IN THOSE MONTHS. DOESN'T THAT SUGGEST THAT THE WHOLESALE PRICE IS INAPPROPRIATELY HIGHER THAN THE RETAIL PRICE?

A. No. For the reasons discussed above, the relationship between AT&T's retail and wholesale prices is of questionable competitive significance. Beyond that, it is important to recognize that the effective price is negative in the early months of serving a retail cashback promotion customer only because AT&T would not yet have earned enough from its monthly price to offset the upfront cashback payment. But, as seen in Table 3 — where a $100 cashback benefit is assumed — the effective price soon turns positive, and the fact that AT&T voluntarily offers these promotions to its retail customers implies that, on average, AT&T's retail customers remain subscribers sufficiently long to offset their upfront cashback benefit. After all, no rational service provider would set an effective promotional price that, on average over time, was near or less than zero on average across its customer base because such prices could not be profitable.[7]

[7] Note also that even though the effective retail price is smaller (more negative) than the wholesale price, the wholesale price is still 14.8 less than the retail price, as required by the Commission's orders and the relevant interconnection agreements.

In reality, negative prices (subsidies) arise when resellers have customers who, on average, have much shorter tenure than those of AT&T and where competition from resellers to supply telecommunications services is replaced by a scramble to collect subsidies from reselling cashback promotions. The fact that under this Commission's uniform percentage wholesale discount method, wholesale prices temporarily exceed retail prices when retail prices are negative does not identify a problem with the Commission's method. What matters for competition is the totality of retail prices over the expected tenure of the average retail customer, and not the effective price in the first month or two.

Q. IN SUMMARY, WHY IS AT&T'S METHOD OF PROVIDING RESELLERS A BILL CREDIT EQUAL TO THE WHOLESALE DISCOUNT OFF OF THE RETAIL CASHBACK AMOUNT RATHER THAN THE ENTIRE CASHBACK AMOUNT APPROPRIATE?

A. Because this method treats a cashback promotion as an effective reduction in the retail price, and Commission decisions and AT&T-CLEC interconnection agreements require that the wholesale price be a fixed percentage discount from the AT&T retail price.

V. RESALE OF LINE CONNECTION CHARGE WAIVER PROMOTIONS

Q. WHAT IS A LINE CONNECTION CHARGE WAIVER ("LCCW") PROMOTION?

A. As described in Attachment D to the Stipulations, an LCCW promotion waives the nonrecurring installation charge for new retail customers that are eligible for the promotion.

Q. FOR THE PURPOSES OF THIS CONSOLIDATED PHASE, HOW DOES AT&T MAKE LCCW PROMOTIONS AVAILABLE FOR RESALE?

A. My understanding is that AT&T initially bills the reseller the retail charge for the line connection less the standard wholesale discount. If the retail line connection charge were $40, AT&T would bill the reseller $34.08 ($40×(1-0.148)). If the reseller submits a timely request for a promotional credit and meets the other requirements of the promotion, AT&T credits the reseller with $34.08, the amount it initially billed the reseller. Under this method, neither the retail customer nor the wholesale customer pays the Line Connection Charge ("LCC"). *See* Stipulations at 6, ¶¶ 7-9.

Q. FROM AN ECONOMIC PERSPECTIVE, HOW SHOULD THE LCC BE TREATED FOR RESALE PURPOSES?

A. The LCC is essentially a telecommunications service that customers generally must buy together with their local exchange service. Thus, it makes sense to treat the two services as a single retail telecommunications service consisting of an upfront, one-time price of $40 and a monthly recurring charge of $75. With a 14.8 percent avoided-cost discount, the corresponding wholesale prices would be a one-time $34.08 ($40×(1-0.148)) credit and a $63.90 ($75×(1-0.148)) monthly recurring charge. These are the same prices that retail and wholesale customers would pay if the telecommunications service and the LCC were treated as separate telecommunications services.

Q. FROM AN ECONOMIC PERSPECTIVE, HOW SHOULD THE LCCW BE PRICED FOR RESALE PURPOSES?

A. Under the promotion, these retail prices would fall to a $0 one-time LCC charge and a $75 per month recurring price for the telecommunications service. Applying the wholesale discount to these retail prices yields wholesale prices of $0 one-time and $63.90 per month recurring. Since the reseller has already been billed $34.08 one-time and the wholesale price for the promotion is $0 one-time, the reseller would be entitled to a one-time bill credit of $34.08.

Alternatively, one could treat the $40 LCCW as a cashback promotion because the value of that promotion is relatively unambiguous (the $40 the retail customer saves) and all customers are likely to value that benefit similarly — like cash. Based on the analysis in the previous section, treating the LCCW as a $40 cashback would produce the identical analysis: the recurring monthly wholesale rate would be unchanged and the qualifying reseller would be entitled to a $34.08 ($40×(1-0.148)) one-time credit.

Q. BUT THE RETAIL CUSTOMER SAVES $40 (ONE-TIME) UNDER THE LCCW AND UNDER YOUR ANALYSIS, THE RESELLER WOULD SAVE ONLY $34.08. HOW CAN THAT BE CORRECT?

A. It is correct because the wholesale prices in my analysis are 85.2 percent of the retail prices, as required by this Commission's decisions and the relevant interconnection agreements. The issue here is precisely the same as was analyzed in the cashback section: whether the proportional or absolute wholesale discount method should be used.

Table 5 shows these calculations. Under the proportional method, the resellers' margin is the required 14.8 percent for both recurring and nonrecurring prices. Hence for any customer tenure, the total wholesale price for the service and the LCC would be 85.2 percent (1-0.148) of the total retail price of service and the LCC, as required. It is true that under the LCCW promotion, the resellers' absolute dollar margin is $5.92 lower than for the ordinary retail service, but that simply reflects the fact that when the retail price falls under a proportional wholesale discount plan, the dollar value of the wholesale discount must also fall.

Under an absolute dollar discount method, the reseller would receive a one-time $40 bill credit instead of $34.08, and its margin (the difference between retail and wholesale prices) would be the same as for ordinary (non-promotional) service: $5.92 one-time and $11.10 per month. However, the percentage wholesale discount would now be higher than the appropriate 14.8 percent by an amount that would depend on the length of tenure of the customer.

Q. FOR THE PURPOSES OF THIS CONSOLIDATED PHASE, WHICH WHOLESALE DISCOUNT METHOD SHOULD THE COMMISSION USE, THE PROPORTIONAL METHOD OR THE ABSOLUTE DOLLAR METHOD?

A. The proportional discount method is and was the only acceptable method of calculating wholesale prices under this Commission's previous decisions and under the relevant interconnection agreements. Parties are free, of course, to petition for a change in the method of calculating wholesale prices for resellers going forward, but those changes cannot apply retroactively.

Q. WHY NOT?

A. I cannot speak to the legal or administrative issues in retroactively changing wholesale rates, but there is an important economic and public policy reason why such retroactive changes would not make sense. The 14.8 percent avoided-cost discount used for resale of all telecommunications services in South Carolina was calculated as an average avoided cost across all retail services. If a Commission decision in this proceeding had the effect of applying a higher wholesale discount to particular retail services in some past period, then a lower discount would have to be applied to the other retail services in that period to keep the average at 14.8 percent.

Moreover, a decision to apply retroactively an absolute dollar margin as opposed to a proportional margin would have different effects on wholesale prices for different services. For services whose retail prices have been increasing, a shift to the absolute dollar method would require that resellers pay *higher* wholesale rates than they were charged under the proportional discount method.[8]

[8] In South Carolina, when the retail price of a telecommunications service changes, the wholesale price changes by 85.2 percent (1-0.148) of that change. Under the (continued...)

Consistent retroactive changes in wholesale rates would have to account for these wholesale price increases as well as the lower wholesale prices from changing the method of reselling promotions.

VI. RESALE OF WORD-OF-MOUTH PROMOTIONS

Q. WHAT IS A WORD-OF-MOUTH PROMOTION?

A. As described in Attachment C to the Stipulations, a Word-of-Mouth promotion is an opportunity for AT&T's current customers to induce their friends and family who are not AT&T subscribers to purchase particular telecommunications services from AT&T. If the new subscriptions qualify, the recommending customer receives a promotional benefit such as a gift card.

Q. FROM AN ECONOMIC PERSPECTIVE, SHOULD SUCH A PROMOTION BE SUBJECT TO THE RESALE OBLIGATION?

A. No. Functionally, this promotion combines a telecommunications service offered by AT&T with a success-based payment for marketing activities undertaken by AT&T's customers. Soliciting new customers for AT&T is not a service that AT&T offers *to* its customers; instead, it is a marketing activity that AT&T induces *from* its customers. And even if it were somehow construed as a service provided to customers, it would be in no sense a *telecommunications* service

(...continued)

absolute dollar discount method, the wholesale price would change by 100 percent of the change in retail prices.

provided by AT&T to its retail customers. Whatever it is, AT&T is under no obligation to resell it to its competitors, any more than AT&T would be obligated to resell the services of its marketing employees to its competitors.

Q. IN ECONOMIC TERMS, WHAT ARE THE PAYMENTS THAT AT&T MAKES TO CUSTOMERS UNDER ITS WORD-OF-MOUTH PROMOTION?

A. Payments under of Word-of-Mouth promotion are best regarded as AT&T marketing expenses. Customers who make referrals of prospective customers are acting as a virtual, part-time sales force of AT&T retail services, and they are compensated for successful referrals by receiving cash rewards. Similar to other marketing expenses (such as a pizza parlor using college students to place sales flyers under the windshield wipers of cars parked at a shopping center), the cost should be viewed as a marketing expense.

Q. BUT ISN'T THE WORD-OF-MOUTH PROMOTION LIKE A CASHBACK PROMOTION THAT IS SUBJECT TO RESALE – IN BOTH CASES, A CUSTOMER WHO HAS PURCHASED TELECOMMUNICATIONS SERVICES FROM AT&T RECEIVES A CASH OR CASH-LIKE BENEFIT FROM AT&T?

A. No. The Word-of-Mouth promotion differs from a cashback promotion in several ways. First, the payment the recipient receives under the Word-of-Mouth promotion has no relationship with the telecommunications services bought by the recipient. The recipient can obtain one, two or more payments under the promotion without changing the telecommunications services she buys.

Second, the payment under the Word-of-Mouth promotion is not tied to the telecommunications services purchased by the recipient of the payment, but instead it is tied to the telecommunications services purchased by others—the new AT&T customers solicited by the recipient.

Third, unlike the recipient of a cashback promotional benefit, the recipient of a "Word-of-Mouth" payment must effectively perform a service of value to AT&T and not merely go through a redemption process to obtain the benefit of the promotion.

Q. HOW WOULD SUCH MARKETING EXPENSES BE ACCOUNTED FOR IN CALCULATING WHOLESALE PRICES?

A. As a marketing expense, these Word-of-Mouth payments would be treated (in theory) as an avoidable cost, and thus they would have been removed from the retail service price in calculating the wholesale price of the promotion paid by resellers.[9]

Q. WHAT WOULD BE THE ECONOMIC EFFECT OF RESELLING A WORD-OF-MOUTH PROMOTIONAL PAYMENT?

A. The effect would be to double-count the promotional payment in calculating the

[9] I say "in theory" because the wholesale discount was calculated on average across all retail services at one point in time. The cost of no particular Word-of-Mouth payment would actually be removed from the reseller's wholesale price. Rather, the average effect of all marketing (and other avoidable expenses) would be removed from the retail price when the wholesale discount was calculated.

wholesale price. As a marketing expense, the promotional payment has already been removed from the wholesale price as part of the avoided-cost calculation. Any additional one-time payment to a reseller of the promotion would effectively reduce the wholesale price twice to account for the single marketing expense.

Q. FROM AN ECONOMIC PERSPECTIVE, SHOULD RESELLERS HAVE TO COMPETE AGAINST WORD-OF-MOUTH AND SIMILAR PROMOTIONS WITHOUT A RESALE DISCOUNT?

A. Yes. Mandatory reselling of what are essentially marketing services—or paying the reseller to provide its own customer-based marketing services—would make a mockery of competition. The theory of mandatory resale in the 96 Act is that the ILEC possesses inherent competitive advantages with respect to the supply of local telecommunications services and that offsetting those advantages through avoided-cost resale would be pro-competitive. Once the ILEC's telecommunications network advantages are offset, ILECs, CLECs, cable companies and wireless carriers are on their own and are expected to exploit their own inherent advantages to compete with one another. Nothing in that logic suggests that ILEC marketing efforts are some kind of essential facility to which competitors must have access or for which competitors must be compensated.

Q. DO FIRMS IN UNREGULATED, COMPETITIVE MARKETS USE PROMOTIONS SUCH AS WORD-OF-MOUTH?

A. Yes. Word-of-mouth and social media marketing is an established marketing discipline; there is even a Word of Mouth Marketing Association at http://womma.org/. According to AllBusiness (a D&B company at http://www.allbusiness.com) the number two of nine techniques for finding new sales prospects is "Solicit referrals. Offer discounts, freebies, or other incentives to customers who bring you new business."[10]

Q. IF THE COMMISSION DETERMINED THAT WORD-OF-MOUTH PROMOTIONS HAD TO BE RESOLD AT AN AVOIDED COST DISCOUNT, HOW WOULD YOU CALCULATE THE WHOLESALE PRICE?

A. Assume an AT&T retail customer received a $50 Word-of-Mouth promotional payment and that qualifying resellers were permitted to resell that promotion (whatever that might mean). To determine the proper wholesale price, from an economic perspective, we must determine whether and to what extent that $50 payment effectively reduced the retail price the AT&T customer paid for her telecommunications service.

If the answer were $50, the previous analysis of cashback and LCCW promotions would show that a qualifying reseller should received a one-time bill credit of $42.60 ($50×(1-0.148)). However, that calculation would drastically overstate the value of the promotion to the retail customer. In order to be eligible for a Word-of-Mouth promotion gift card, the finder must actually perform a service successfully for the ILEC, and the value of the customer's time and effort

[10] http://www.allbusiness.com/sales/selling-techniques/873-1.html .

must be subtracted from the $50 payment in evaluating its effect on the retail price. Most AT&T customers do not receive Word-of-Mouth payments, from which we can conclude that they value their time and effort at more than $50 and that the option offered in the Word-of-Mouth promotion—a one-time $50 payment in exchange for successfully inducing friends and family to subscribe to AT&T—has no value. Those relatively few customers who do receive Word-of-Mouth payments implicitly value the promotion at less than $50 but more than $0. Because the promotion has no effect on the retail price for the vast majority of customers, I would leave the wholesale price of the telecommunications service unchanged.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

Table 1.

Resale Discount	14.80%	
Retail Price	$75.00	
Wholesale Price	$63.90	(Retail Price less Resale Discount)
Retail Cashback Amount	$50.00	
Wholesale Cashback Amount	$42.60	(Retail Price less Resale Discount)

Months Service Is Kept		Retail	Wholesale	Retail-Wholesale Margin Proportional	Retail-Wholesale Margin Absolute
1	Monthly Price	$75.00	$63.90	14.80%	$11.10
	Prorated Cashback (Amount/Months)	$50.00	$42.60		
	Effective Monthly Rate	$25.00	$21.30	14.80%	$3.70
2	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$25.00	$21.30		
	Effective Monthly Rate	$50.00	$42.60	14.80%	$7.40
3	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$16.67	$14.20		
	Effective Monthly Rate	$58.33	$49.70	14.80%	$8.63
4	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$12.50	$10.65		
	Effective Monthly Rate	$62.50	$53.25	14.80%	$9.25
5	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$10.00	$8.52		
	Effective Monthly Rate	$65.00	$55.38	14.80%	$9.62
6	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$8.33	$7.10		
	Effective Monthly Rate	$66.67	$56.80	14.80%	$9.87
7	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$7.14	$6.09		
	Effective Monthly Rate	$67.86	$57.81	14.80%	$10.04
8	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$6.25	$5.33		
	Effective Monthly Rate	$68.75	$58.58	14.80%	$10.18
9	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$5.56	$4.73		
	Effective Monthly Rate	$69.44	$59.17	14.80%	$10.28
10	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$5.00	$4.26		
	Effective Monthly Rate	$70.00	$59.64	14.80%	$10.36
11	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$4.55	$3.87		
	Effective Monthly Rate	$70.45	$60.03	14.80%	$10.43
12	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$4.17	$3.55		
	Effective Monthly Rate	$70.83	$60.35	14.80%	$10.48
700	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$0.07	$0.06		
	Effective Monthly Rate	$74.93	$63.84	14.80%	$11.09

Table 2.

Resale Discount	14.80%
Retail Price	$75.00
Wholesale Price	$63.90 (Retail Price less Resale Discount)
Retail Cashback Amount	$50.00
Wholesale Cashback Amount	$50.00

Months Service Is Kept		Retail	Wholesale	Retail-Wholesale Margin Proportional	Retail-Wholesale Margin Absolute
1	Monthly Price	$75.00	$63.90	14.80%	$11.10
	Prorated Cashback (Amount/Months)	$50.00	$50.00		
	Effective Monthly Rate	$25.00	$13.90	44.40%	$11.10
2	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$25.00	$25.00		
	Effective Monthly Rate	$50.00	$38.90	22.20%	$11.10
3	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$16.67	$16.67		
	Effective Monthly Rate	$58.33	$47.23	19.03%	$11.10
4	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$12.50	$12.50		
	Effective Monthly Rate	$62.50	$51.40	17.76%	$11.10
5	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$10.00	$10.00		
	Effective Monthly Rate	$65.00	$53.90	17.08%	$11.10
6	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$8.33	$8.33		
	Effective Monthly Rate	$66.67	$55.57	16.65%	$11.10
7	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$7.14	$7.14		
	Effective Monthly Rate	$67.86	$56.76	16.36%	$11.10
8	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$6.25	$6.25		
	Effective Monthly Rate	$68.75	$57.65	16.15%	$11.10
9	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$5.56	$5.56		
	Effective Monthly Rate	$69.44	$58.34	15.98%	$11.10
10	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$5.00	$5.00		
	Effective Monthly Rate	$70.00	$58.90	15.86%	$11.10
11	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$4.55	$4.55		
	Effective Monthly Rate	$70.45	$59.35	15.75%	$11.10
12	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$4.17	$4.17		
	Effective Monthly Rate	$70.83	$59.73	15.67%	$11.10
700	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$0.07	$0.07		
	Effective Monthly Rate	$74.93	$63.83	14.81%	$11.10

Table 3.

Resale Discount	14.80%	
Retail Price	$75.00	
Wholesale Price	$63.90	(Retail Price less Resale Discount)
Retail Cashback Amount	$100.00	
Wholesale Cashback Amount	$85.20	(Retail Price less Resale Discount)

Months Service Is Kept		Retail	Wholesale	Retail-Wholesale Margin Proportional	Retail-Wholesale Margin Absolute
1	Monthly Price	$75.00	$63.90	14.80%	$11.10
	Prorated Cashback (Amount/Months)	$100.00	$85.20		$14.80
	Effective Monthly Rate	-$25.00	-$21.30	14.80%	-$3.70
2	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$50.00	$42.60		
	Effective Monthly Rate	$25.00	$21.30	14.80%	$3.70
3	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$33.33	$28.40		
	Effective Monthly Rate	$41.67	$35.50	14.80%	$6.17
4	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$25.00	$21.30		
	Effective Monthly Rate	$50.00	$42.60	14.80%	$7.40
5	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$20.00	$17.04		
	Effective Monthly Rate	$55.00	$46.86	14.80%	$8.14
6	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$16.67	$14.20		
	Effective Monthly Rate	$58.33	$49.70	14.80%	$8.63
7	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$14.29	$12.17		
	Effective Monthly Rate	$60.71	$51.73	14.80%	$8.99
8	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$12.50	$10.65		
	Effective Monthly Rate	$62.50	$53.25	14.80%	$9.25
9	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$11.11	$9.47		
	Effective Monthly Rate	$63.89	$54.43	14.80%	$9.46
10	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$10.00	$8.52		
	Effective Monthly Rate	$65.00	$55.38	14.80%	$9.62
11	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$9.09	$7.75		
	Effective Monthly Rate	$65.91	$56.15	14.80%	$9.75
12	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$8.33	$7.10		
	Effective Monthly Rate	$66.67	$56.80	14.80%	$9.87
700	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$0.14	$0.12		
	Effective Monthly Rate	$74.86	$63.78	14.80%	$11.08

Table 4.

Resale Discount	14.80%
Retail Price	$75.00
Wholesale Price	$63.90 (Retail Price less Resale Discount)
Retail Cashback Amount	$100.00
Wholesale Cashback Amount	$100.00

Months Service Is Kept		Retail	Wholesale	Retail-Wholesale Margin Proportional	Retail-Wholesale Margin Absolute
1	Monthly Price	$75.00	$63.90	14.80%	$11.10
	Prorated Cashback (Amount/Months)	$100.00	$100.00		
	Effective Monthly Rate	-$25.00	-$36.10	-44.40%	$11.10
2	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$50.00	$50.00		
	Effective Monthly Rate	$25.00	$13.90	44.40%	$11.10
3	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$33.33	$33.33		
	Effective Monthly Rate	$41.67	$30.57	26.64%	$11.10
4	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$25.00	$25.00		
	Effective Monthly Rate	$50.00	$38.90	22.20%	$11.10
5	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$20.00	$20.00		
	Effective Monthly Rate	$55.00	$43.90	20.18%	$11.10
6	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$16.67	$16.67		
	Effective Monthly Rate	$58.33	$47.23	19.03%	$11.10
7	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$14.29	$14.29		
	Effective Monthly Rate	$60.71	$49.61	18.28%	$11.10
8	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$12.50	$12.50		
	Effective Monthly Rate	$62.50	$51.40	17.76%	$11.10
9	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$11.11	$11.11		
	Effective Monthly Rate	$63.89	$52.79	17.37%	$11.10
10	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$10.00	$10.00		
	Effective Monthly Rate	$65.00	$53.90	17.08%	$11.10
11	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$9.09	$9.09		
	Effective Monthly Rate	$65.91	$54.81	16.84%	$11.10
12	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$8.33	$8.33		
	Effective Monthly Rate	$66.67	$55.57	16.65%	$11.10
700	Monthly Price	$75.00	$63.90		
	Prorated Cashback (Amount/Months)	$0.14	$0.14		
	Effective Monthly Rate	$74.86	$63.76	14.83%	$11.10

Table 5.

Resale Discount	14.80%	
Retail Price	$75.00	
Wholesale Price	$63.90	(Retail Price less Resale Discount)
Line Connection Charge	$40.00	
LCCW Credit	$34.08	(Retail Price less Resale Discount)

			Retail-Wholesale Margin	
	Retail	**Wholesale**	**Proportional**	**Absolute**
Ordinary Retail				
Telecom Service (monthly)	$75.00	$63.90	14.80%	$11.10
LCC (one-time)	$40.00	$34.08	14.80%	$5.92
Promotion Proportional Method				
Telecom Service (monthly)	$75.00	$63.90	14.80%	$11.10
LCC (one-time)	$40.00	$34.08	14.80%	$5.92
Promotion benefit (one-time)	-$40.00	-$34.08	14.80%	-$5.92
Promotion Fixed Dollar Method				
Telecom Service (monthly)	$75.00	$63.90	14.80%	$11.10
LCC (one-time)	$40.00	$34.08	14.80%	$5.92
Promotion benefit (one-time)	-$40.00	-$40.00	0.00%	$0.00
Proportional - Fixed (monthly)	$0.00	$0.00		$0.00
Proportional - Fixed (one-time)	$0.00	$5.92		-$5.92

EXHIBIT WET-1

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Dr. Taylor received a B.A. *magna cum laude* in Economics from Harvard College, an M.A. in Statistics and a Ph.D. in Economics from the University of California at Berkeley. He has taught economics, statistics, and econometrics at Cornell and the Massachusetts Institute of Technology and was a post doctoral Research Fellow at the Center for Operations Research and Econometrics at the University of Louvain, Belgium.

At NERA, Dr. Taylor is a Special Consultant. Previously he headed the Boston office and was Director of the Telecommunications Practice. He has worked primarily in the field of telecommunications economics on problems of state and federal regulatory reform, competition policy, terms and conditions for competitive parity in local competition, quantitative analysis of state and federal price cap and incentive regulation proposals, and antitrust problems in telecommunications markets. He has testified on telecommunications economics in U.S. federal and state courts and the New Zealand High Court as an economic and statistical expert and has participated in telecommunications regulatory proceedings before state public service commissions, the Federal Communications Commission, the Canadian Radio-Television and Telecommunications Commission, the New Zealand Commerce Commission, the Indonesian antitrust authority, the Comisión Federal de Telecomunicaciones de México, and federal and state congressional committees. He has appeared as a telecommunications commentator on PBS Radio and on The News Hour with Jim Lehrer.

He has published extensively in the areas of telecommunications policy related to access and in theoretical and applied econometrics. His articles have appeared in numerous telecommunications industry publications as well as *Econometrica*, the *American Economic Review*, the *International Economic Review*, the *Journal of Econometrics*, *Econometric Reviews*, the *Antitrust Law Journal*, *The Review of Industrial Organization*, and *The Encyclopedia of Statistical Sciences*. He has served as a referee for these journals (and others) and the National Science Foundation and has served as an Associate Editor of the *Journal of Econometrics*.

Education

UNIVERSITY OF CALIFORNIA, BERKELEY
Ph.D., Economics, 1974

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M.A., Statistics, 1970

HARVARD COLLEGE
B.A., Economics, 1968
(Magna Cum Laude)

Professional Experience

NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC. (NERA)
1988- Special Consultant, Senior Vice President, Office Head, Telecommunications Practice Director.

BELL COMMUNICATIONS RESEARCH, INC. (Bellcore)
1983-1988 Division Manager, Economic Analysis, formerly Central Services Organization, formerly American Telephone and Telegraph Company: theoretical and quantitative work on problems raised by the Bell System divestiture and the implementation of access charges, including design and implementation of demand response forecasting for interstate access demand, quantification of potential bypass liability, design of optimal nonlinear price schedules for access charges and theoretical and quantitative analysis of price cap regulation of access charges.

BELL TELEPHONE LABORATORIES
1975-1983 Member, Technical Staff, Economics Research Center: basic research on theoretical and applied econometrics, focusing on small sample theory, panel data and simultaneous equations systems.

MASSACHUSETTS INSTITUTE OF TECHNOLOGY
Fall 1977 Visiting Associate Professor, Department of Economics: taught graduate courses in econometrics.

CENTER FOR OPERATIONS RESEARCH AND ECONOMETRICS
Université Catholique de Louvain, Belgium.
1974-1975 Post Doctoral Research Associate: basic research on finite sample econometric theory and on cost function estimation.

CORNELL UNIVERSITY
1972-1975 Assistant Professor, Department of Economics. (On leave 1974-1975.) taught graduate and undergraduate courses on econometrics, microeconomic theory and economic principles.

Miscellaneous

1985-1995 Associate Editor, *Journal of Econometrics*, North-Holland Publishing Company.
1990-2009 Board of Directors, National Economic Research Associates, Inc.
1995- 2006 Board of Trustees, Treasurer, Episcopal Divinity School, Cambridge, Massachusetts.

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Pennsylvania Public Utility Commission (Docket Nos. A-310580F9, A-310401F6, A-310407F3, A-312025F5, A-310752F6, A-310364F3) on behalf of Verizon Communications, Inc. and MCI, Inc., direct testimony regarding economic effects of the proposed merger. Filed July 1, 2005. Rebuttal testimony filed August 12, 2005.

New Jersey Board of Public Utilities (BPU Docket No. TM0530189) on behalf of Verizon Communications, Inc. and MCI, Inc., direct testimony regarding economic effects of the proposed merger. Filed July 8, 2005. Rebuttal testimony filed August 19, 2005.

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State Corporation Commission of Virginia (Case No. PUC-2005-00051) Statement regarding the effects of the proposed Verizon-MCI merger. Filed August 30, 2005

Illinois Commerce Commission (Docket No. 06-0027) on behalf of SBC Illinois. Direct testimony concerning classification of services as competitive. Filed January 23, 2006. Rebuttal testimony filed March 24, 2006.

Georgia Public Service Commission, (Docket No. 19341-U) on behalf of BellSouth Telecommunications, Inc., regarding pricing of delisted unbundled network elements. Direct testimony filed February 10, 2006.

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Florida Public Service Commission (Docket No. 080159), on behalf of BellSouth Telecommunications, Inc., Embarq Florida, Inc., Verizon Florida LLC, and Windstream Florida, Inc. Report "Intermodal Competition in Florida Telecommunications," (with H. Ware), filed March 14, 2008.

California Public Utilities Commission (Rulemaking 08-01-005) on behalf of AT&T California, declaration regarding unbundling and retirement of copper loop plant. Filed March 14, 2008. Rebuttal testimony filed May 28, 2008.

Illinois Commerce Commission (Docket No. 08-0569) on behalf of AT&T Illinois. Direct testimony concerning classification of services as competitive. Filed October 20, 2008. Rebuttal testimony filed December 23, 2008.

Petition to her Excellency, the Governor in Council, By MTS Allstream Inc., *In the Matter of Telecom Decision CRTC 2008-118 and Telecom Regulatory Policy CRTC 2009-34*. Reply Comments of Bell Canada Regional Communications, Limited Partnership and Bell Canada, Appendix 2, Declaration of William E. Taylor on behalf of Bell Canada, March 11, 2009.

California Public Utilities Commission (Rulemaking 09-05-006) on behalf of AT&T California, declaration regarding exemption from regulation of property transactions. Filed June 26, 2009.

State of Connecticut, Department of Public Utility Control, (Docket Nos. 09-04-21, 08-12-04) on behalf of Neutral Tandem, direct testimony concerning pricing of local tandem transit services. Filed September 1, 2009. Supplemental testimony filed September 17, 2009.

Federal Communications Commission (WC Docket No. 05-25) on behalf of Verizon and Qwest. Workshop presentation regarding special access pricing flexibility, July 19, 2010.

California Public Utilities Commission (Rulemaking 08-01-005) on behalf of AT&T California, declaration regarding unbundling and retirement of copper loop plant. Filed March 14, 2008. Rebuttal testimony filed May 28, 2008.

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California Public Utilities Commission (Rulemaking 09-05-006) on behalf of AT&T California, declaration regarding exemption from regulation of property transactions. Filed June 26, 2009.

State of Connecticut, Department of Public Utility Control, (Docket Nos. 09-04-21, 08-12-04) on behalf of Neutral Tandem, direct testimony concerning pricing of local tandem transit services. Filed September 1, 2009. Supplemental testimony filed September 17, 2009.

Federal Communications Commission (WC Docket No. 05-25) on behalf of Verizon and Qwest. Workshop presentation regarding special access pricing flexibility, July 19, 2010.

STATE OF SOUTH CAROLINA	)	
	)	CERTIFICATE OF SERVICE
COUNTY OF RICHLAND	)	

The undersigned, Nyla M. Laney, hereby certifies that she is employed by the Legal Department for BellSouth Telecommunications, Inc. d/b/a AT&T South Carolina ("AT&T") and that she has caused the Direct Testimony of Dr. William E. Taylor in Docket Nos. 2010-14-C, 2010-15-C, 2010-16-C, 2010-17-C, 2010-18-C and 2010-19-C to be served upon the following on August 27, 2010:

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(OneTone Telecom, Inc.)
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